THE NEW YORK RULE OF DAMAGES IN SPECULATIVE TRANSACTIONS

1. Unauthorized Sales

It should be remembered that in New York legal title to stock carried by a broker for a customer on margin is in the customer, so that the relationship is that of pledgor and pledgee.[1] Consequently an unauthorized sale by the broker is a conversion.[2] It had for a long time been the rule in New York that a plaintiff in an action for conversion might recover as damages the greatest value reached by the commodity converted from the time of the conversion down to the time of trial, provided that the action had been brought within a reasonable time and diligently prosecuted.[3] For some time this rule had been applied to stock cases.[4] The theory underlying this rule was that the wrongful sale might be disregarded and the plaintiff given the benefit of the most favorable sale he might have been able to make up to the time of trial.[5] It soon became manifest that this rule was not equitable in the case of speculative commodities,[6] as it presupposed the willingness and ability of the plaintiff to carry the same through all fluctuations, and then assumed that he would be able to pick the top of the market. The result, of course, gave the plaintiff much more than he would have made out of his venture had there been no conversion and made it practically impossible for the brokers who had acted erroneously though in good faith to protect themselves. That no such result should follow was finally decided in *Baker* v. *Drake*.[7] In that case Judge Rapallo held that the plaintiff should have only the value of his speculative bargain, saying:

"An amount sufficient to indemnify the party

---

[1] Markham *v.* Jaudon (1869) 41 N. Y. 235; Content *v.* Banner (1906) 184 N. Y. 121, 76 N. E. 913.

[2] Markham *v.* Jaudon, *supra,* footnote 1, p. 245.

[3] Scott *v.* Rogers (1864) 31 N. Y. 676; Burt *v.* Dutcher (1866) 34 N. Y. 493.

[4] Markham *v.* Jaudon, *supra,* footnote 1; Romaine *v.* Allen (1863) 26 N. Y. 309, where damages were allowed based on the price reached during the trial itself.

[5] Romaine *v.* Allen, *supra,* footnote 4, p. 313; Baker *v.* Drake (1873) 53 N. Y. 211, 215.

[6] Matthews *v.* Coe (1872) 49 N. Y. 57; see also Suydam *v.* Jenkins (1850) 3 Sandf. 619.

[7] *Supra,* footnote 5.

> injured for the loss, which is the natural, reasonable and proximate result of the wrongful act complained of, and which a proper degree of prudence on the part of the complainant would not have adverted, is the measure of damages. . . . The advance in the market price of the stock from the time of the sale up to a reasonable time to replace it, after the plaintiff received notice of the sale, would afford a complete indemnity. Suppose the stock, instead of advancing, had declined after the sale, and the plaintiff had replaced it, or had full opportunity to replace it, at a lower price, could it be said that he sustained any damage by the sale; would there be any justice or reason in permitting him to lie by and charge his broker with the result of a rise at some remote subsequent period?"[8]

In other words, the customer's recovery was controlled by the speculative character of the transaction. If he decided to continue the speculation he must repurchase, and in such case his damages obviously would be the difference between the amount he would have to pay and the price of the unauthorized sale, unless that was greater, in which case he would have suffered no damages. If, on the other hand, the customer did not desire to continue the speculation, it is clear that he should not be entitled to any greater damages. To make up his mind what to do the customer is given a reasonable time in which to seek advice and procure funds to repurchase.

The same rule applies to transactions in cotton and wheat for future delivery,[9] and to cases where the stock held by the broker had been fully paid for by the customer.[10]

The reasonable period ordinarily begins to run only after the customer has acquired knowledge of the wrongful sale. Nor is the customer entitled to high prices reached between the time of the sale and his knowledge of it, since, had he desired to sell, he should have so ordered the broker.[11] Moreover, the customer, should he desire to repurchase after learning of the sale would not have to pay the high prices intermediate the sale and his discovery. On the other hand, the customer is not to be deprived

---

[8] *Supra,* footnote 5, at pp. 216-7.

[9] Hurt *v.* Miller (1907) 120 App. Div. 833, 105 N. Y. Supp. 775; affd. (1908) 190 N. Y. 553, 83 N. E., 1126.

[10] Wright *v.* Bank of the Metropolis (1888) 110 N. Y. 237, 18 N. E. 79.

[11] Burnham *v.* Lawson (1907) 118 App. Div. 389, 103 N. Y. Supp. 482.

of his damages because of a decline between the time of the sale and his knowledge of it. Regardless of the future course of the market, however, the customer can always recover, either in an action on the account, or an action for conversion, the amount for which the stock was actually sold.[12]

In a recent case it was held immaterial that the discovery did not take place for several years after the conversion, where no facts which would have prompted inquiry came to the knowledge of the customer before that trial.[13] In that case, however, the conversion did not consist of an unauthorized sale, but of a sale in an unauthorized manner. In other words, the customer had directed the sale and the broker had purchased the stock himself. The customer did not learn of this until the trial of the action and was permitted to recover heavy damages because of the increase in the market value of the stock. This seems to violate the principle of *Baker* v. *Drake*, as pointed out in the dissenting opinion,[14] because it could not be presumed that the customer would carry the stock for this long time, especially as it declined after the sale. Moreover, the customer got the exact price he desired for his stock, so it would hardly seem that he was damaged at all. On the other hand, it is fundamental that a customer may, upon discovery of the fact, repudiate a purchase by the broker himself and treat the stock as still in the broker's possession. There would seem to be no alternative between a practical recognition of a broker's right to purchase himself, where the price received is not affected, and between applying the rule of damages approved by the court.

A similar situation was somewhat differently dealt with in a case involving transactions in cotton for future delivery, in which certain customs of the Cotton Exchange were held to be, in effect, purchases by the broker, and so illegal.[15] Here also the customer did not discover the so-called purchases by the broker until the time of the trial. This was some time after

---

[12] McIntyre *v.* Whitney (1910) 139 App. Div. 557, 124 N. Y. Supp. 234; affd. (1911) 201 N. Y. 526, 94 N. E. 1096. The lower court had limited the plaintiff to the highest price which the stock had reached within a reasonable time after discovery of the conversion, which was much less than the sale price. This was held to be error as it failed to understand the reason for the rule of Baker *v.* Drake and also enabled the broker to profit by his own wrong.

[13] Stiebel *v.* Lissberger (1915) 166 App. Div. 164, 151 N. Y. Supp. 822.

[14] *Supra,* footnote 5.

[15] Cohen *v.* Rothschild (1918) 182 App. Div. 408, 169 N. Y. Supp. 659.

maturity of all the contracts dealt in, so that it was not possible for the court to treat them as still in existence and fix damages on the basis of their value at the time of discovery. On the other hand the court did not wish to give practical recognition to these customs by allowing only nominal damages; hence it adopted the expedient of throwing out any losses the customer suffered by reason of such trades. This result has no basis in principle because it makes the customer's damages depend, not alone on the trade held illegal, but also on the offsetting trade in all respects legal. It was probably adopted, however, because the rule of the Stiebel Case[16] could not be applied in view of the maturity of the contracts and because no other rule was available. It must then be taken as the rule to be applied in cotton and wheat cases where discovery took place after the maturity of the contract.

To sum up, therefore, a customer may always recover the amount realized upon the sale,[17] and may recover more if, during a reasonable period after the discovery of the sale, the stock has advanced;[18] and in the case of futures which have matured before discovery, the customer may recover any loss sustained in connection with the particular trade.[19]

There are, however, cases in which the reasonable period begins to run before the customer has actual knowledge of the conversion. If the customer has knowledge of facts sufficient to put him upon inquiry which would have disclosed the conversion, the reasonable period begins with the knowledge of these facts.[20] It has recently been held that the mere closing of the Exchange following the outbreak of the European war did not put the customer on inquiry, where he had a substantial equity in his stock at the time of the closing, but that he was put on inquiry when he learned that his broker had gone out of business.[21]

On the other hand, where the customer had been called for margin and knew his stocks were depreciating in a panicky market, he was held to have been put on inquiry and entitled to no

---

[16] *Supra*, footnote 13.

[17] *Supra*, footnote 12.

[18] Baker *v.* Drake, *supra*, footnote 5; Wright *v.* Bank of Metropolis, *supra*, footnote 10; Stiebel *v.* Lissberger, *supra*, footnote 13.

[19] *Supra*, footnote 15.

[20] Mayer *v.* Monzo (1917) 221 N. Y. 442, 117 N. E. 948.

[21] O'Connor *v.* Gilmore (N. Y. App. Div. 3rd Dept. 1919), N. Y. L. J. 1439.

damages, as the stocks had declined within a reasonable time after he should have known of the conversion.[22]

An interesting question arises where the customer's ignorance of the conversion is due to his failure to examine a notice received from the broker. Where the notice was sent and not received it would seem clear that the customer should not be limited, as notice can in no way be brought home to him. On the other hand, it does not seem equitable that a customer should be permitted to keep a broker's notice without looking at it and then claim damages to which he would not have been entitled had he examined the notice. No case has been found by the writer in which the situation arose.

In this connection it should be remembered that a customer can never recover unless he promptly repudiates the wrongful sale,—for otherwise he will be deemed to have ratified, or will be estopped from questioning it.[23] It would probably be held that failure to examine a statement received would constitute a ratification after a reasonable time had elapsed. If, however, the customer does examine the statement before the expiration of such time and then disaffirms, when would he be charged with knowledge so as to start the period in which damages might be assessed? No clear answer can be made, and it would seem that the receipt of the statement should start the time running.

What constitutes a reasonable period in which to repurchase and so fix damages depends upon the circumstances.[24] The impression prevails that 30 days constitutes such period and it has been so held in a number of cases.[25] Other periods have, however, also been upheld as reasonable.[26] In the case just cited, it appeared that the customer had made up his mind what to do shortly after the conversion when he ordered the brokers to sell the cotton previously converted, which, however, they refused to do, claiming that he had been sold out. The court fixed the damages as of the day of the customer's direction to sell, holding that the plaintiff could not speculate at the broker's expense after he had taken a definite position.

Of course where a broker sells short for a customer without

---

[22] *Supra,* footnote 20.

[23] See Hope *v.* Lawrence (1867) 50 Barb. 258.

[24] *Supra,* footnote 9.

[25] Colt *v.* Owens (1882) 90 N. Y. 368.

[26] *Supra,* footnote 9.

proper instructions, the customer may simply disregard the trade altogether, and so no question of damages arises.

2. Unauthorized Purchases

A purchase on the long side not authorized by the customer may similarly be disregarded by him. But where the purchase is made to close out a short sale previously made, the same questions arise as upon a conversion of stock.

The courts have uniformly held that such unauthorized purchase could be repudiated, and then completely disregarded by the customer.[27] The customer may therefore, at any time, after prompt repudiation require the broker to buy in the short stock, and sue for the difference between the price at which the stock could have been bought upon such order and the price at which the unauthorized purchase was made.[28] No question of reasonable time is involved, provided the wrongful purchase has been promptly repudiated. The unauthorized purchase is held not to affect the customer who is short, any more than it would affect a customer who had no position in the market. The same conclusion is reached in transactions for the future delivery of commodities.[29] This rule has none of the defects of the old conversion rule, because the customer must manifestly maintain his margin in order to be in a position to compel the broker to execute his purchase order. Nor does it penalize the broker by allowing to the customer damages based on the almost miraculous foresight of picking the most favorable price. On the other hand, this rule requires the customer to continue dealing with a broker with whom he is already in dispute, and prevents the broker from requiring additional margins in case of a temporary advance in the market, so as to remain consistent with his claim that the customer is out of the market.

It is apparent that in the case of the covering of short sales the courts have applied a theory entirely different from that applied in the case of sales of long stock. There would seem to be no reason why the same rule should not be applied to both situations. Certainly, if an unauthorized purchase can be disregarded

---

[27] White *v.* Smith (1874) 54 N. Y. 522; Rogers *v.* Wiley (1892) 131 N. Y. 527, 30 N. E. 582; Barber *v.* Ellingwood, No. 1, (1909) 135 App. Div. 549, 120 N. Y. Supp. 947.

[28] White *v.* Smith, *supra*, footnote 27.

[29] Campbell *v.* Wright (1890) 118 N. Y. 594, 23 N. E. 914.

by the customer, an unauthorized sale can be also. That the sale was made against a previous purchase should make no difference. The customer could act as if the original stock were still held by the broker and either order it sold or demand its delivery, and thus altogether eliminate the question of reasonable time. That a refusal by the broker to deliver upon demand by the customer and the tender of carrying charges stock once wrongfully sold constituted a second conversion has indeed been held, although there the demand was in fact within a reasonable time after discovery of the first conversion.[30]

It is clear, however, that the courts have not adopted this rule in the case of sales, because they felt that it would permit the customer to carry the stock through various fluctuations while the broker was prevented from claiming margin because of his contention that the customer was out of the market. In other words, it was realized that if the market declined the customer would hold the broker to the sale price, and if it advanced, would give a new order at the higher price or demand the stock and claim damages accordingly.

But does not this very vice affect the existing rule covering a broker's unauthorized purchases against his customer's short sales? If the market goes down after the improper purchase the customer is entitled to, and invariably will claim damages; while if it goes up he will ratify and claim the benefit of the original purchase.

There seems to be no good reason why the conversion rule should not be generally applied. In both cases the customer is speculating. If by a wrongful sale he is deprived of his opportunity to hold stock for an advance, he is equally by a wrongful purchase deprived of his opportunity to wait for a decline before covering his short sale. If in the one case it has been held equitable that he should decide within a reasonable time whether or not to continue the speculation, it is also equitable that he should similarly so decide in the other. So, if his damages in the first case are limited by the amount he would have to pay to replace the stock wrongfully sold, equally should they in the second case be limited by the price at which he resells the stock wrongfully bought in. The reasoning of the court in *Baker* v. *Drake*[31] applies just as well to the case of wrongful purchase.

---

30 *Supra,* footnote 13.

31 *Supra,* footnote 5.

To the ordinary speculator or broker it makes no difference which side of the market the initial trade is on. This is especially true of trading in future, as in such transaction there is no delivering or borrowing, no interest or dividends, and short selling and long buying are in every step and book entry identical. It would, therefore, appear that there is no warrant, either in theory or because of business practice, why the law should differentiate the two kinds of trades, impose different duties upon the parties and apply different rules of damage.

The courts should require that a customer dissatisfied either with a wrongful sale or a wrongful purchase against previous commitments on the opposite side of the market, repudiate promptly, and that within a reasonable time he either repurchase or resell so as to put himself back in his original position; or if he does not care to do so, that he be limited in his damages to the difference between the unauthorized trade and the price at which the replacing trade could have been made.

3. Failure to Execute Orders

If a broker accepts an order from a customer which could have been executed by the exercise of reasonable care the broker will be liable for his failure to fill the order.[32] It is not within the purpose of this article to consider the circumstances under which such liability arises. But it is proposed to consider what rule of damages is applicable where liability has been established.

The courts of New York seem to have applied to this class of cases the same rule applied to wrongful covering of short sales. They seem to have reached this result by a process of reverse reasoning. In other words, just as they held that the initial wrongful purchase might be disregarded and damages claimed on the basis of a subsequent order and purchase, so here it has been held that a subsequent sale or purchase might be disregarded and damages claimed on the basis of the original unexecuted order. In *Allen* v. *McConihe*[33] it was held that the customer upon objecting to the non-execution of his order to sell had in effect abandoned the stock to the broker, although he had not so stated, and was therefore entitled to the value of the stock at the price it should have been sold at, less any credit later given him by the broker upon the actual sale of the stock. The case seems, however, to

[32] *Supra,* footnote 1, at p. 239.
[33] (1891) 124 N. Y. 342, 26 N. E. 812.

have been decided on the ground that the customer did not have legal title in the stock, and therefore could not have sold it except by taking it up from the brokers.[34] The court overruled the suggestion that the customer give a second order to sell so as to limit his damages, on the ground that such direction might be deemed a waiver. But it has never been held than an order to repurchase stock wrongfully sold constituted a waiver.

In *Policastro* v. *Sprague*[35] the customer in fact gave a second order which was held not to constitute a waiver of the broker's failure to execute the first order. In this case, in spite of the fact that the jury found that the stock could have been sold within a reasonable time after the customer learned that his order had not been filled, at the price named by him in that order, recovery was had of the difference between the price of the original order and the amount realized upon the execution of the second order. The court apparently based its decision upon the customer's contention that there was no way in which he could sell the stock, and ignoring the fact that the customer could, after learning of the broker's default, have sold the stock at the original price in just the same way as he subsequently sold it at a lower price.

Here again the rule adopted by the court permits the customer to speculate at the broker's expense. If the market goes up the customer will be glad to forgive the non-execution and take advantage of the more favorable market. On the other hand, if the market goes down he can sit still and make the broker pay the loss. The broker cannot protect himself without admitting that he has made a mistake.

It would be perfectly simple to require the customer to take a definite position within a reasonable time after discovering the non-execution. He should be required either to order a resale if he desired to terminate the speculation, or if he did not, he should not be permitted to continue the speculation at the broker's expense, but should be limited in his damages to the difference between the price of the unexecuted order and the lowest price reached by the stock within the reasonable period.

4. Conclusion

It thus appears that two divergent rules have been developed.

---

[34] *Supra*, footnote 33, at p. 348.

[35] (1916) 175 App. Div. 417, 161 N. Y. Supp. 912.

In the case of wrongful sales the customer is limited in his damages by the highest price the stock or commodity reaches during reasonable period after discovery of the wrongful sale, so that if during this period the price is lower than that of the sale no damages are obtainable. In the case of wrongful purchases or failures to execute orders, either of sale or of purchase, the customer is bound by no limitation of time. In the case of wrongful purchase he may recover the difference between the price at which the wrongful purchase was made and the price of his order subsequently given. In the case of non-execution he is entitled to the price at which the order should have been executed, subject to any saving made by reason of a later execution. In both of these last cases the customer is in a position where he can speculate at the broker's expense. In both of them the rule applied to wrongful sales could easily be applied. No objection can be taken to the application of this rule to all the cases which may arise, either of wrongful execution or wrongful non-execution of orders. If this were done there would be a single rule applicable to all speculative transactions. The customer would always be required to repudiate promptly the broker's wrong, whether of commission or omission, and would within a reasonable time after discovery be required to place himself in the position he originally desired to be in, either by repurchasing, reselling or giving new orders to sell or to buy. If he did not give the new orders he would be limited in his damages by the extreme price reached during the reasonable period. In this way both broker and customer would be protected and harmony brought into the law.

OSMOND K. FRAENKEL

New York City